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TAGS: EFIN ECON RS

SUBJECT: RUSSIA'S MARKETS PLUNGE AFTER PUTIN'S STATEMENTS
ABOUT MECHEL

Classified By: Acting DCM Alice Wells, Reasons 1.4 (b/d).

Summary

¶11. (C) Prime Minister Putin's public criticism of Mechel, Russia's largest specialty steelmaker and second-largest coking coal producer, has highlighted the fragility of Russia's stock market, exposed possible divisions within the country's leadership, and spooked investors -- some of whom see the case as a reminder of the Yukos affair. In the wake of the Mechel case, as well as the flight of TNK-BP CEO Bob Dudley, the Russian stock markets has declined dramatically, losing more than USD 60 billion in shareholder value in a matter of days. Experts differ on the motivations behind Putin's attacks on Mechel, with some contending the company and its chairman, Igor Zyuzin are being used as scapegoats for the government's failure to reign in inflation, while others contend that Putin and his inner circle are out to destroy Zyuzin and seize his assets, a la the YUKOS affair. Whatever the cause, Putin's comments contrast with the GOR's supposed preference, expressed during the TNK-BP dispute, that senior officials should not interfere in commercial matters, and further undermine confidence in the government's commitment to economic reform and modernization. End Summary.

Putin Targets Mechel

¶12. (U) During a July 24 conference in Nizhniy Novgorod on Russia's metallurgical industry development, Prime Minister Putin said that the industry's transfer pricing practices and tax avoidance schemes had resulted in limited supplies domestically and had raised prices. He singled out Mechel, accusing the company of selling coking coal domestically for twice the price at which the firm sold the material abroad. In the same address, Putin said that Mechel President Igor Zyuzin, absent from the conference because of "health reasons," had engaged in tax evasion and called upon the Investigative Committee of the General Procuracy to work with the Federal Antimonopoly Service on determining whether Mechel's raw materials pricing practices complied with applicable laws.

¶13. (SBU) News reports later explained that the Federal Antimonopoly Service had initiated a review of Mechel's coking coal pricing policy in May. FAS statements indicated Mechel lacked "technical and economic justification" for refusing to sign a long-term coking coal supply contract with Novolipetsk Steel (NLMK), according to business daily

Kommersant. The FAS probe was also examining whether Mechel had used transfer pricing to minimize its tax obligations. Vedomosti reported that FAS documents related to the investigation noted that Lichtenstein-based Mechel Trading Ltd. sold Mechel's coking coal through its worldwide representation offices. Deputy Prime Minister Igor Sechin, recently installed to oversee industry development policies, had also reportedly received complaints from GazpromNeft, SurgutNefteGaz and the Fund for Steel Pipe Industry Development about rising prices for metals, notably steel pipe. Center for Political Technologies Deputy Director Boris Makarenko, who is a member of Medvedev's Institute for Modern Development think tank, told us that Mechel's first mistake was to anger its partners.

¶4. (U) In the aftermath of Putin's initial statement, the country's stock markets dropped sharply. Mechel's shares fell almost 30 percent, leading the decline of other steelmakers such as Severstal, whose shares dropped 10 percent, and MMK, which slipped more than 9 percent. Declines in other blue chip stocks such as Gazprom (down 3.7 percent) and Sberbank (down 7 percent) pushed overall market capitalization down approximately USD 58 billion.

Damage Control and a Second Round

¶5. (U) Almost immediately after Putin's statements hit the press, top officials moved to clarify the meaning of his censure of Mechel and to minimize the effect on the markets. On July 24 Industry and Trade Minister Viktor Khristenko was quoted as saying that Putin's comments related only to

Mechel's sales of coke and not the company's core steelmaking business. For its part, Mechel acknowledged wrongdoing and expressed its determination to work with the government to resolve any issues. On July 28, Presidential Advisor Dvorkovich promised that the Russian government planned to look into the Mechel case in a "civilized manner," implying that the heavy-handed approach that had characterized the Yukos affair would be avoided.

¶6. (U) Just as things seemed to be calming down, Putin spoke out against Mechel for a second time on July 28. At a Presidium meeting of the core cabinet, Putin claimed that Mechel had been selling coking coal abroad for more than four times more than domestic sales (on July 24 he had said only for twice as much) and complained that those sales denied the state its full measure of tax revenues. Stock markets again dipped following Putin's statement, losing another estimated USD 8 billion in share value, with Mechel's shares falling to 50 percent of their pre-July 24 value.

The Inflation "Conundrum"

¶7. (C) UralSib Chief Strategist Chris Weafer explained Putin's comments in the context of Russia's "inflation conundrum," that the country has a long-term need for infrastructure improvement and a short-term problem of rising price levels. "Moreover, the Central Bank cannot materially reduce the money supply since raising interest rates has tended to draw in net capital from abroad. Against this backdrop, the report on complaints from energy companies about their costs for steel pipe may have genuinely raised Putin's ire.

¶8. (C) Weafer speculated that the power sharing with President Medvedev (i.e., the tandemocracy) had removed the "normal safety valve of apportioning blame." Medvedev cannot point the finger at the Prime Minister for the government's failure to control prices, as Putin did during his presidency, but Putin "still needed a villain to deflect blame from the government's failings," according to Weafer. Less credibly to us, Makarenko maintained that Putin did not anticipate the magnitude of the effect of his comments, and

attributed this to the learning curve associated with the former President's hands-on management of the economy.

YUKOS Part 2?

¶ 9. (C) Business media outlets such as *Kommersant* and *Vedomosti* quoted market analysts who compared the Mechel incident with the beginning of the Yukos affair. Some of our contacts were hesitant to make the direct linkage. Zyuzin had not followed Khodorkovskiy's example of becoming involved in politics, according to Alfa Bank Chief Economist Natalia Orlova. Novolipetsk Metallurgical Company (NLMK) President Vladimir Lisin enjoyed access to Putin and may have worked to send Mechel a message that long-term contracts for inputs were preferable to higher-priced spot market purchases. Orlova suggested that Lisin and others may have their eyes on Mechel's coking coal assets but expressed doubt that steelmakers were interested in removing Zyuzin and taking over Mechel's core business.

¶ 10. (C) Weafer observed that Zyuzin was very aware of the Khodorkovskiy story and was much more inclined to strike a conciliatory, accommodating tone with the GOR. Mechel, he noted, issued a statement the day after the conference in Nizhniy Novgorod that had emphasized the importance of supporting the government's goals and of building long-term relationships with "key partners." Weafer also argued that repeating the Yukos affair was "not at all in the government's interest" since it would jeopardize the flow of much-needed capital into Russia. "Without increased investment flows, the objectives of the Putin Plan simply cannot be achieved," Weafer said. The GOR did have an interest, however, in making sure that oligarchs and big business prioritize the domestic economy and support the state's economic policy efforts.

¶ 11. (C) However, Oleg Voronin, an associate of the Moscow Carnegie Center, said that according to his sources, linked to the security services, Severstal chairman Aleksey

Mordashov, together with Magnitogorsk Metal Kombinat (MMK) chairman Viktor Rashkin, and United Metallurgical Company (OMK) chairman Anatoliy Sedykh had worked together to persuade Putin to take action against Mechel. Voronin alleged that Putin was reluctant to become involved, but was reportedly convinced to act after the metals magnates contributed to the Fund to Support Development of the Russian Language -- a charity headed by Lyudmila Putina. Voronin's hypothesis was that the ultimate goal of Putin's public criticisms of Mechel was to drive down the company's share price and to facilitate a take-over of the company. At a minimum, metals producers planned to force Mechel to sign long-term contracts at fixed prices for coal deliveries.

Comment

¶ 12. (C) The verdict of the marketplace with respect to the GOR's intervention in Mechel and the non-intervention in TNK-BP has been swift and negative. We also expect to see heightened investor concerns expressed in the form of greater risk premiums, increasing the price of doing business in Russia. This fallout may give us a stronger argument to make with the GOR about the importance of the reputational issue as an obstacle to investment. However, the Mechel case is further evidence that the GOR's plans to modernize and reform the economy will not be allowed to interfere with the financial interests of regime insiders.

RUBIN